DOMTAR

1977 Annual Report

Highlights

		1977	1976
Financial	Sales	**$1,009,507,537**	$ 886,768,907
	Income taxes — Current	**$ 12,770,000**	$ 3,730,000
	Income taxes — Deferred	**$ 950,000**	$ 4,170,000
	Net earnings	**$ 26,840,202**	$ 10,562,617
	Cash flow from operations	**$ 68,169,609**	$ 49,788,131
	Working capital	**$ 236,855,559**	$ 247,963,914
	Capital investments	**$ 50,683,749**	$ 49,508,810
	Funded debt — long term	**$ 173,939,000**	$ 190,499,000
	Shareholders' equity	**$ 347,853,655**	$ 333,911,672
	Number of preference shareholders	**1,537**	1,613
	Number of common shareholders	**22,244**	23,330
	Common shares outstanding	**14,827,300**	14,827,300
	Number of employees	**16,815**	17,520
	Employees' salaries, wages and benefits	**$ 297,255,000**	$ 273,858,000
Per common share	Earnings	**$ 1.78**	$ 0.68
	Dividends	**$ 0.80**	$ 1.00
	Cash flow	**$ 4.56**	$ 3.32
	Shareholders' equity	**$ 22.65**	$ 21.67

The annual meeting of Domtar Inc. will be held at 4 p.m. on Thursday, April 27, 1978 in the Chateau Champlain Hotel, Montreal.

Domtar Inc. 1978
Legal Deposit 1st quarter 1978
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Les actionnaires qui préféreraient recevoir leurs rapports en français voudront bien en aviser le Secrétaire de Domtar Inc.

Report of the Directors to the Shareholders

Earnings in 1977 were significantly better than those reported for 1976. The most important factor contributing to the improvement was the reduced value of the Canadian dollar relative to the United States dollar. This not only increased revenues obtained from export sales of products priced in United States dollars but also created a disadvantage for foreign manufactured goods, primarily exports from the United States to Canada.

Two other factors also had an important impact on earnings. The amount of production lost through strikes, which severely depressed earnings last year, was much less in 1977. In addition, there was a reduction in the effective income tax rate, primarily through the introduction of a 3% inventory allowance by the Federal government and the availability of greater investment credits.

Despite these favourable conditions, the Corporation's overall competitive position, like that of other Canadian manufacturing firms, improved only marginally during 1977. The continuation of an intolerably high inflation rate in Canada has to be of serious concern.

Results for the Chemicals group were slightly improved over 1976 due to increased sales and cost reduction programs.

Operating profit of the Construction Materials group approximated that earned in 1976. A marked improvement in the results achieved by the group's principal product lines was offset by the unsatisfactory performance of the new particleboard and Cladboard® manufacturing operations at Huntsville, Ontario.

Considerable improvement over the 1976 results was realized in the Pulp & Paper Products group. However, costs continued to rise for labour, materials and energy with the result that the Canadian pulp and paper industry continues to be uncompetitive on the international market and its resulting profit and cash generation remains at an unacceptably low level.

Despite slightly lower sales, resulting from the disposal of its Converted Papers division, the Packaging group achieved a considerable improvement in operating profit. The negotiated settlement found for the serious labour problems affecting its plant at East Angus, Quebec, and increased volume for packaging products were factors in the better performance.

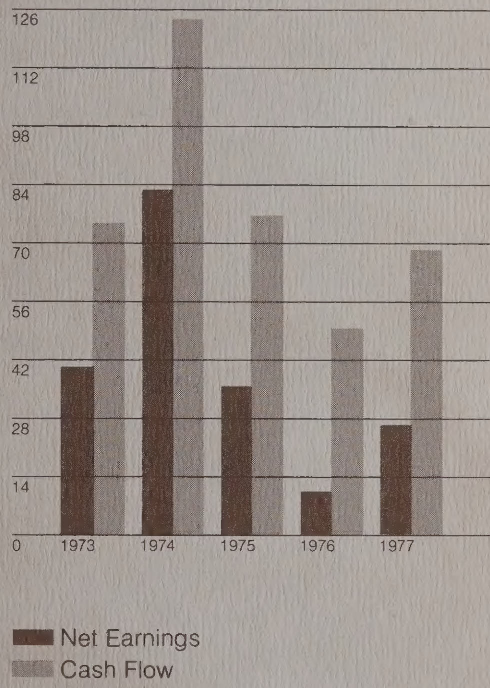
Sales and Net Earnings

In 1977, the Corporation's sales exceeded $1 billion for the first time. Sales in 1976 were below $900 million. The 13.8% increase stemmed from improved markets for certain product lines, particularly those associated with the Newsprint, Fine Papers, Packaging and Construction Materials operations. Resulting in part from increased revenues from export sales following the devaluation of the Canadian dollar and a reduction in the effects of strikes on production activities, the higher sales level yielded earnings of $26.8 million or $1.78 per common share. This compares with the very low 1976 earnings of $10.6 million or 68¢ per common share.

Income taxes charged against 1977 earnings represent an overall effective income tax rate of 33% of accounting income compared with 40% for 1976. The reduction in the tax rate results mainly from the introduction in 1977 of the 3% inventory allowance and an increase in the investment tax credits available to the Corporation. Any incremental increase in profits generated from operations is taxable at the full statutory tax rate of about 43%. If pre-tax earnings were calculated on a price level inflation accounting basis, as outlined on page 26, the effective tax rate for 1977 would have been approximately 80%.

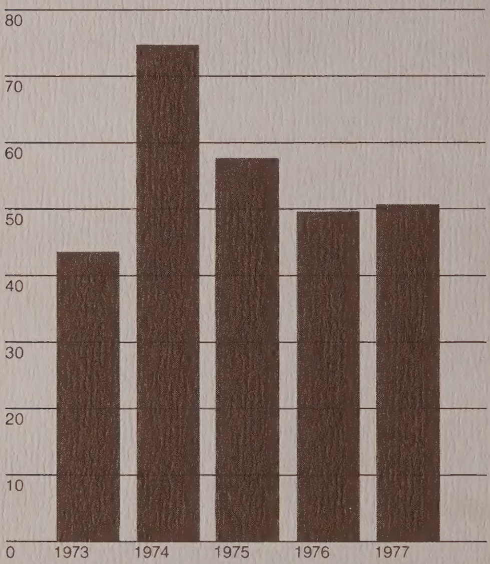
An analysis of sales and earnings before interest, income taxes and minority interest by the four main organizational and product groups of the Corporation for the years 1977 and 1976 appears in the following table.

Net Earnings and Cash Flow
(millions of dollars)



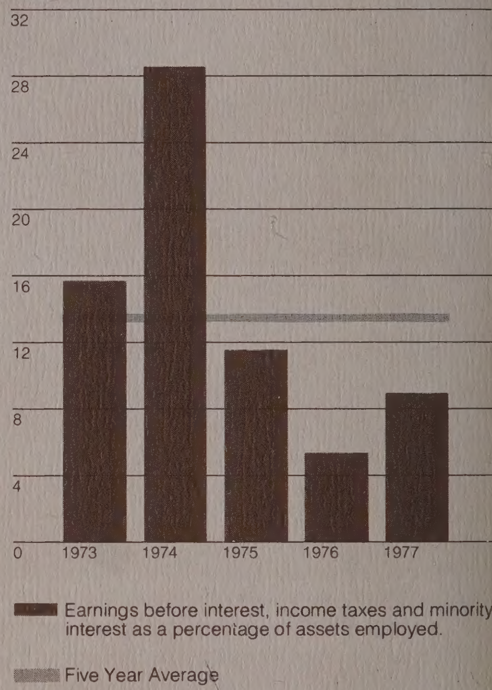
	1977 (Millions of dollars) Sales	1977 Operating profit	1976 Sales	1976 Operating profit/(loss)
Pulp and Paper	**$ 460.4**	**$ 6.8**	$374.2	$(12.1)
Packaging	**194.6**	**13.6**	197.9	8.8
Construction Materials	**197.4**	**10.4**	172.0	10.3
Chemicals	**169.8**	**20.1**	156.7	16.9
Inter-group eliminations	**(12.7)**	**—**	(14.0)	0.1
	$1,009.5	**50.9**	$886.8	24.0
Gain on disposal of fixed assets		**—**		1.6
Corporate income		**7.8**		8.2
Earnings before interest, income taxes and minority interest		**$58.7**		$33.8

Capital Investments
(millions of dollars)



Equity/Debt Position

Percentage Return Before Taxes on Assets Employed
(Percent)



Dividends

During 1977, the Corporation paid a dividend of 80¢ per common share. Over the past five years, common share dividends have represented about 46% of net earnings applicable to the common shareholders. The Corporation in 1977 declared dividends of $1.00 per share on its preference shares.

Capital Investment Program and Related Financing

The Corporation spent $38.0 million in 1977 on capital investments as part of its continuing program to improve its cost competitiveness and exploit opportunities for further development of its product lines throughout North America. An additional $15.5 million was disbursed in connection with the acquisition of shares, not previously owned by the Corporation, in two companies.

Major expenditures during the year included the expansion of the lime kiln facilities at Joliette, the installation of refuse handling facilities at the Lebel-sur-Quévillon mill and increasing to 100% from 49% the Corporation's ownership of the Murdock-Domtar Inc. wood processing and sawmill complex at Mistassini, all located in Quebec; and, in Ontario, a fibre ceiling panel production line at Cornwall and pollution abatement improvements to the Beachville lime plant. The Corporation also acquired the 49% minority interest in Chemical Developments of Canada Limited, making that company a wholly owned subsidiary. In addition, the Corporation announced a $22.0 million expansion program for the gypsum wallboard plant at Caledonia, Ontario, scheduled for completion during 1979.

This on-going investment program was financed through cash generated by operations and supplemented by the proceeds of Sinking Fund Debentures issued in recent years.

During the year, the Corporation made repayments of $8,190,000 in respect of Sinking Fund Debentures under previous issues. Its total long term funded debt at December 31, 1977, amounted to $173.9 million. The effect of these repayments, together with the increase in the book value of the shareholders' equity, improved the long term equity/debt ratio from about 1.75:1 at the end of 1976 to 2.0:1 at December 31, 1977.

Source and Use of Funds

Despite the substantial improvement in the Corporation's reported earnings per common share, the need, fuelled by inflation, for ever more working capital to support existing levels of activity and meet constantly increasing plant and equipment replacement costs requires a higher level of profit and resultant cash flow than was generated during 1977.

The Corporation has made a considerable effort to communicate to the community at large that traditional accounting concepts which, by definition, do not reflect the impact of inflation tend to provide an exaggerated view of a corporation's financial well-being. Domtar clearly exemplifies this reality as its cash position, despite the significant improvement in earnings, decreased by $14.0 million during the year even though the Corporation's overall productive base did not change substantially.

The table on page 5 summarizes the Source and Use of Funds of the Corporation over the last five years and indicates the continuing need to generate more funds from operations so as to maintain its productive capacity, finance the inflationary increases in working capital, invest in new business opportunities and provide shareholders with a return on their investment. This situation is confirmed by applying the inflation accounting methods recommended in the

Statement of Source and Use of Funds

for the years ended December 31

	5 year total	1977	1976	1975	1974	1973
				(millions of dollars)		
Funds provided by the manufacture and sale of products	**$391.6**	**$68.2**	$49.8	$76.3	$123.6	$73.7
Proceeds from the disposal of:						
Fixed assets and related working capital	**43.4**	**12.5**	6.5	4.7	1.0	18.7
Investments (net)	**12.8**	**0.1**	0.5	4.8	7.4	—
	447.8	**80.8**	56.8	85.8	132.0	92.4
Funds required for:						
Maintaining existing facilities	**204.4**	**30.9**	37.4	40.9	60.5	34.7
Additional investment in working capital (excluding taxes payable) attributable to the impact of inflation on production costs and selling prices	**48.4**	**15.1**	10.7	(33.5)	51.1	5.0
Changes in income and other taxes payable	**(3.6)**	**(4.2)**	1.8	35.8	(21.6)	(15.4)
Redemption of funded debt	**39.6**	**8.2**	8.4	8.0	7.1	7.9
Other	**11.6**	**4.4**	1.1	1.1	2.8	2.2
	300.4	**54.4**	59.4	52.3	99.9	34.4
Funds available for distribution to shareholders and for new investments	**147.4**	**26.4**	(2.6)	33.5	32.1	58.0
Used for:						
Dividends	**91.1**	**12.4**	18.4	24.3	26.5	9.5
Investments in new facilities and acquisitions	**91.1**	**28.0**	20.0	17.3	13.4	12.4
	182.2	**40.4**	38.4	41.6	39.9	21.9
Balance of funds before financing	**(34.8)**	**(14.0)**	(41.0)	(8.1)	(7.8)	36.1
New issues of funded debt	**97.9**	**—**	48.9	49.0	—	—
Increase (decrease) in cash	**63.1**	**(14.0)**	7.9	40.9	(7.8)	36.1
Cash, net of bank indebtedness, at beginning of period	**9.8**	**86.9**	79.0	38.1	45.9	9.8
Cash, net of bank indebtedness, at end of period	**$ 72.9**	**$72.9**	$86.9	$79.0	$38.1	$45.9

Report of the Ontario Committee on Inflation Accounting which shows the funds that theoretically should be set aside to maintain existing operations. This profile, appearing on page 27, indicates that virtually all of the cash flow generated in 1977 is required to replace existing inventories and fixed assets

Return on Investment

Using traditional historical accounting concepts, the percentage of profit before financing expenses, income taxes and minority interest to assets employed showed an increase from 5.3% in 1976 to 8.9% in 1977. Although the relative increase in absolute terms is encouraging, the return on investment achieved for 1977 only approximates current returns which could be realized on investments in government fixed income low risk securities. If inflation accounting concepts were applied to the Corporation's financial results, the return on investment figures would decrease significantly to 4.5% for 1977 compared with 1.8% for 1976.

Whatever the basis of measurement used, the return on investment must be increased for the Corporation to cope with inflationary demands on cash, exploit technology and markets, contribute to the Canadian economy and pay a satisfactory return to the common shareholder.

Working Capital

As indicated previously, the working capital position of the Corporation continues to increase as a result of inflation. Over the last five years, the net increase in operating working capital has aggregated $48.4 million, most of which is attributable to inflationary pressures.

The Corporation was pleased to note that the Federal and Provincial governments have appreciated, if only partially, that the inflationary demands of operating working capital require additional cash investment and that the mandatory use of historical accounting concepts results in illusory inventory profits being fully taxable. The introduction during 1977 of the 3% inventory allowance by government is applauded as a step in the right direction to alleviate the artificial tax burden. It is hoped that governments will increase this percentage allowance to the extent necessary to eliminate the taxation of such misleading profits.

The overall working capital position of the Corporation continues to reflect a healthy position with the ratio of current assets to current liabilities approximating 2.6 to 1.

Employee Relations

The economic difficulties facing the Corporation in 1977 and the steps taken to overcome them had a significant effect on the employee relations climate. Nevertheless, as noted elsewhere in this report, the improvement in the Corporation's financial performance is attributable to the intensive efforts and dedication of all Domtar employees.

The deferment of the closing of the manufacturing operations at the Kraft Paper and Board mill in East Angus led to the introduction of an employee relations program involving the complete and frank disclosure to all employees of financial information concerning the mill's operations. Similar communications programs are being introduced at other locations.

The need to be cost competitive and the effects of the Anti-Inflation Board's controls were the dominant elements in the collective bargaining environment in 1977. Of the 52 settlements reached in the year, 25 were for a one year term. The Corporation faces a record 89 negotiations in 1978. These include the collective agreements for most of the primary mills in the Pulp & Paper Products group.

Renewal of agreements expiring on or after April 14, 1978, will no longer be subject to controls. Although much has been said about voluntary wage restraint as part of the decontrol process, the Corporation believes that the critical economic and social values of a cost competitive manufacturing sector in Canada are now more clearly recognized by employers, employees and their representatives, governments and the general public.

Research

In 1977, the Central Research Department pursued its threefold function of providing technical support for the solution of problems arising within operating groups; conducting long term research with a view to developing new processes and products for introduction when existing ones have attained maturity; and developing and maintaining the research skills and facilities appropriate to a company with a wide range of products and markets.

As a result, Central Research worked on a range of operating problems, including the quality classification of wood chips, the identification of properties of thermomechanical pulp which result in good printing characteristics and the operation of the fluid bed recovery system at the Cornwall, Ontario, mill. Long range projects were primarily of a proprietary nature, focussing on fresh areas of interest in forest chemicals, new construction materials and innovative products and processes in the fibre industry. Some long range projects received substantial support from outside agencies, notably the Federal government. They include the production of animal food supplements from tree foliage, sensors for measuring paper roughness, pollution abatement studies and, very recently, thermal energy storage problems.

Public Affairs

In the face of continuing economic and political uncertainties, the Corporation pursued its dialogue on economic matters with key public servants by openly and frankly discussing its perceptions and concerns with them.

In the Province of Quebec, Domtar submitted two important briefs to government commissions. In its submission to the Parliamentary Commission on the Charter of the French language in Quebec, the Corporation concluded that the proposed language legislation would significantly impair its ability to operate effectively its head office and supporting staff functions in Quebec unless major revisions were made to the legislation governing English language schooling and language requirements within the head offices of national and international corporations headquartered in Quebec. So far, amendments have not been introduced which would alleviate our concern with regard to this legislation. The Corporation was not invited to appear before this Parliamentary Commission.

A brief was also presented to the Permanent Commission of the Department of Natural Resources and Lands and Forests on "The Prospects for the Pulp and Paper Industry in Quebec" and Domtar appeared before it. The Corporation argued that current cost/price pressures on its pulp and paper operations prevent it from generating sufficient cash to pay interest, service debt,

provide a minimal return to the shareholders and have funds remaining for reinvestment in the business. It recommended that steps be taken to improve the investment climate, including increased economic education for all sectors of the community; that governments appreciate more fully the need to control inflation and take effective action to do so; and that unions, government and business each recognize and accept their particular and joint responsibilities for improving the economic environment for the pulp and paper industry so that it will become cost competitive in North America.

Donations to registered Canadian charitable organizations in the fields of health and welfare, education and scholarships, community causes and cultural activities totalled $270,000 in 1977 compared with $316,150 in 1976. As in past years, these donations supplemented the money, time and efforts voluntarily contributed by thousands of Domtar employees throughout the organization to ensure the success of a range of fund drives and other deserving community projects. The Corporation contributed $22,000 to Canadian political parties during the year.

Outlook for 1978

The prospects for the coming year are that Domtar will continue to benefit from a depressed Canadian dollar relative to its American counterpart. Although an improved market is anticipated for newsprint and fine paper products, there is little likelihood of a significant recovery of the pulp markets which deteriorated so catastrophically in 1977. Market conditions for the Corporation's major packaging, chemicals and construction materials products are expected to be favourable, enabling these groups to achieve modest improvements in sales and earnings. A correction in facility design of a part of the new particleboard and Cladboard® plant in Huntsville should result in improved profit performance by this facility in 1978.

Numerous labour contracts are due for renewal in 1978. Confidence that the economic climate will permit Domtar to increase its earnings is based on the assumption that the Corporation and the various labour unions with which it deals will be able to reach settlements consistent with the economic environment affecting individual facilities without experiencing significant strikes.

Long Term Goals

Looking ahead, the Corporation recognizes the need to broaden its asset earning base to provide a more balanced presence in its main business lines. As tariffs between Canada and the United States are likely to be substantially reduced over the next decade, Domtar is assessing the future competitive situation for its existing facilities so as to position itself to function more effectively in the years ahead. In doing this, the Corporation accords high priority to seeking out specific investment opportunities in North America.

In recent times, steps have been taken to close down or sell operations which have not met or are not expected to meet minimum financial profit and cash flow returns. The rationalization of operations will be pursued and specific steps will be taken whenever warranted. The Corporation has not recently increased its operating base through major acquisitions, although approximately $91.1 million has been spent during the past five years to acquire or construct new facilities in Canada and the United States. The Corporation's present strategy is to pursue its search for opportunities and ensure that any move meets its investment criteria in terms of financial return and compatibility with its existing business lines.

Board of Directors

Early in 1978, Mr. J. Thomas Timmins of Montreal asked to retire as a Director. The Board, which has regretfully accepted his resignation, wishes to thank him for the significant contribution which he made to the Corporation during his tenure. Mr. Timmins was elected to the Domtar Board on May 17, 1966.

Mr. Robert Després, President of the Université du Québec, was elected to fill the vacancy.

Appreciation

The Directors wish to express their appreciation to all Domtar employees for their skills, efforts and commitment, without which the improved results in 1977 would not have been achieved.

On behalf of the Board.

Maxwell C. G. Meighen
Chairman of the Board

Alex D. Hamilton

Alex D. Hamilton
President and Chief Executive Officer

Principal Products:

Domtar Fine Papers
Uncoated and coated fine papers for the printing, business and converter trades as well as specialty papers such as diazo base, glassine, greaseproof and carbonizing.

Domtar Forest Products
Green and kiln dried spruce and pine dimension lumber and studs.

Domtar Newsprint
Standard newsprint and groundwood specialty and coated publication grade papers.

Domtar Pulp
Bleached and unbleached softwood and hardwood sulphate pulp; semi-bleached softwood sulphate pulp; and unbleached sulphite pulp.

Dominion Envelope Company Limited
An extensive range of envelopes and specialty bags.

Last year's forecast for the group was that 1977 would be a difficult year, especially for its primary producing mills. In view of anticipated cost escalations, particularly in labour, wood and energy, it was emphasized that priority of management efforts would be directed to rigorous cost reductions, increased productivity and the control of working capital.

While the forecast has proved accurate, significant improvement was registered over the 1976 performance. However, the Canadian pulp and paper industry continued to be uncompetitive with its counterpart in the United States, particularly with regard to wage rates, and considerable discipline will have to be exercised by all parties, including governments, if Canada is to be restored to a more viable position. Important cost cutting measures were implemented in all operations but the full benefit to be derived from these moves is not reflected in the financial statements for the year as market weaknesses prevented full utilization of productive capacity.

The group generated $460.4 million of sales and $6.8 million of operating profit. As such, 1977 sales exceeded those of 1976 by $86.2 million and operating profit increased by $18.9 million.

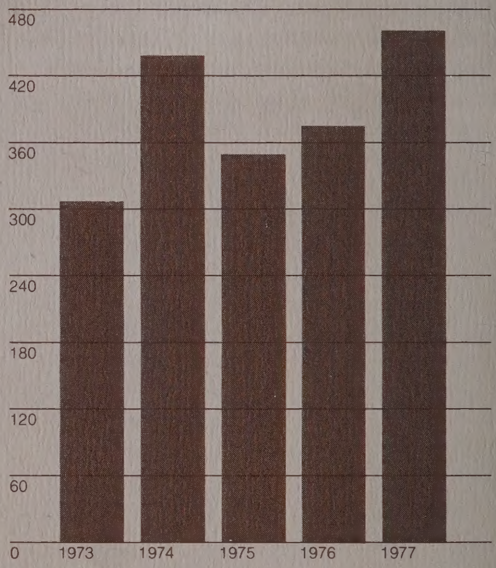
Significant steps were taken by Domtar Forest Products to control raw material costs. The result was a 5% reduction in wood costs on a volume in excess of two million tons. Pulpwood inventories were also substantially reduced during the year. Some reduction in wood chip prices is expected in 1978. This will help to narrow the unfavourable differential between our costs and those of our competitors in Western Canada and the United States.

Markets for various products improved over 1976, except in pulp where a combination of excess capacity, extremely high North American and Scandinavian inventories and sluggish demand caused a disastrous erosion of prices. Bleached kraft softwood pulp closed out the year at some $70 U.S. per short ton lower than the prices prevailing a year earlier. In Western European markets, prices fell by a comparable amount. A return to higher selling prices is essential to re-establish the viability of our kraft pulp operations. It is difficult to forecast either when inventories will return to more normal levels or the minimum combination of price level and operating rates at which profits will be restored. The market pulp business over the next few years is unlikely to earn a sufficiently high return on investment to warrant any increase in capacity.

Fine paper markets were weak for the first half of the year and many of our paper machines ran at less than capacity. Prices were reduced severely in an aggressive effort to recover the market share lost to imports from the United States following the long six month strike in late 1975 and early 1976. With volume being regained during 1977, the Canadian dollar floating down to around 91¢ versus the United States dollar and American producers able to sell more in their own country, it was possible to implement a number of selected price increases during the last half of the year. The outlook is for further price improvements in 1978. In the longer term, however, the possibility of a stronger Canadian dollar, together with the prospect of lowered Canadian tariffs and continued high unit labour costs, pose a grave threat to the future of the Canadian fine papers industry.

North American lumber demand was strong for most of the year despite mid year fluctuations. This situation is likely to continue until the second quarter of 1978 when some fall-off is expected. This should be followed by a somewhat stronger second half. In Europe, lumber demand was light but showed signs of strengthening during the

Pulp and Paper Products Sales
(millions of dollars)



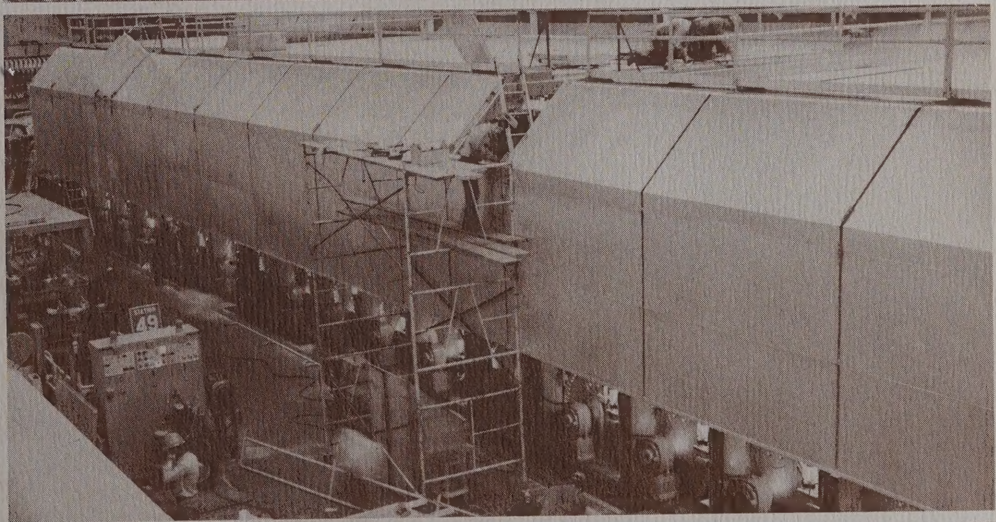
last six months of the year. The upward trend is expected to continue in 1978, resulting in some improvement in prices and volume. Domtar's lumber operations in 1977 saw the completion of the start-up phase of the stud mill at Lebel-sur-Quévillon, as well as the commencement of the lumber operations of Murdock-Domtar Inc. at Mistassini. This mill is now operating at about 85% of design capacity.

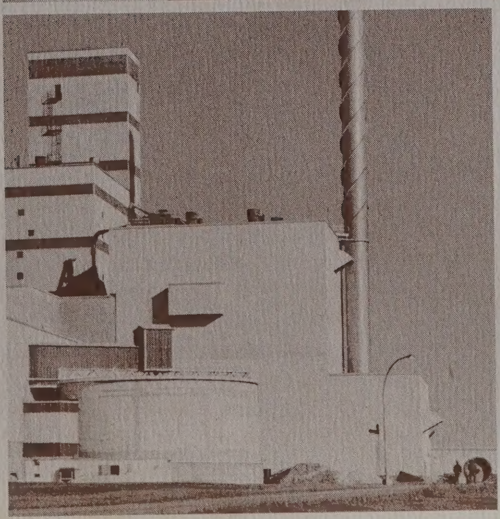
The results for Domtar Newsprint were seriously affected by the strike at Donnacona, Quebec, which lasted until the end of June. In the ensuing months, it was necessary to rebuild productivity at the mill and re-establish market position. The major renovation of the two newsprint machines at Dolbeau, Quebec, was completed in February. A good start-up was experienced and both machines have been performing well since that time. The supply-demand relationship was poor early in the year but, by year-end, operating rates of 90% and more were being achieved. During 1978, the rate could increase.

Dominion Envelope Company Limited, a subsidiary, enjoyed another good year. The Envelope division performed up to expectations while the Bag division continued to face competition from high density plastic bags.

The Pulp & Paper Products group spent $15.7 million on capital improvements in 1977: $5.4 million in Fine Papers and the

envelope business, $2.7 million in Forest Products, $5.4 million in Pulp and $2.2 million in Newsprint. In 1978, expenditures will amount to only about $12.5 million in recognition of the reduced cash generating capacity of the group over the past several years.





Pulp & Paper

At the end of 1977, Domtar acquired full ownership of the Murdock-Domtar Inc. stud mill in Mistassini, Quebec.

A major renovation of the two newsprint machines in Dolbeau, Quebec, was completed early in the year.

A $15 million "hog boiler" installation went into operation at the Lebel-sur-Quévillon pulp mill in September. The boiler, which burns bark and other forest residues, helps to lower costs by reducing the mill's consumption of imported fuel oil.

Cornwall Coated Card is ideal for a variety of specialty print items as indicated in this display. Shown (from left to right) are Marketing Research Manager Jim Purvis, General Sales Manager John Thullner, Product Line Manager Tom Drouin, all from the Domtar Fine Papers group.

Principal Products:

Kraft Paper and Board division
Linerboard, corrugating medium, kraft papers and boxboards for package manufacture.
Corrugated Containers division
Corrugated shipping containers and displays.
Composite Can division
Composite cans and tubes.
Specialty Papers division
Plain and reinforced gummed tapes, photocopy paper and coated papers for wrappings.

Operations for 1977 were more satisfactory than in the strike depressed prior year. Despite slightly lower sales, a considerable improvement in operating profit was achieved. 1977 operating profit was $13.6 million compared to $8.8 million in 1976.

The primary thrust of the group's business is in its corrugated shipping container operation. Although this business had suffered excessively from major strikes in 1975 and 1976, it was able to recapture most of its market share in the highly competitive conditions which prevailed throughout 1977. As part of a continuing cost reduction program, upgrading of facilities at the division's box making factories included the installation of automatic splicing and stacking equipment as well as impregnation facilities. Continued growth and innovation are planned to enable Domtar to expand in this important market.

The group's Converted Papers division had operated a kraft paper converting, bag manufacturing and distribution business for the past fifteen years. Due to continued unsatisfactory financial performance, the sale of this division was effected in October, 1977, releasing about $13 million of capital.

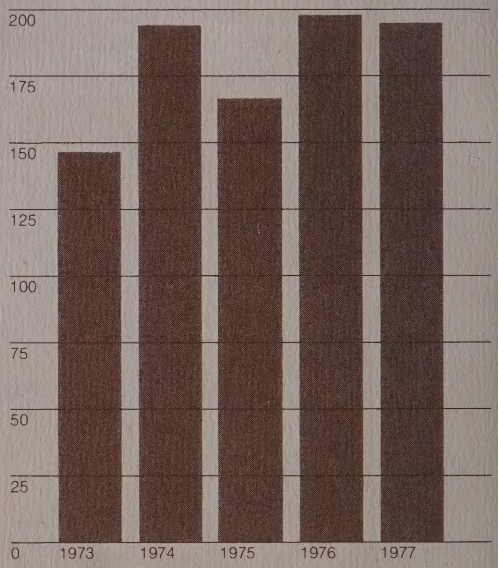
The year 1977 was an active and rewarding one for the Composite Can division. This business benefited from developments initiated in earlier years, particularly in food packaging.

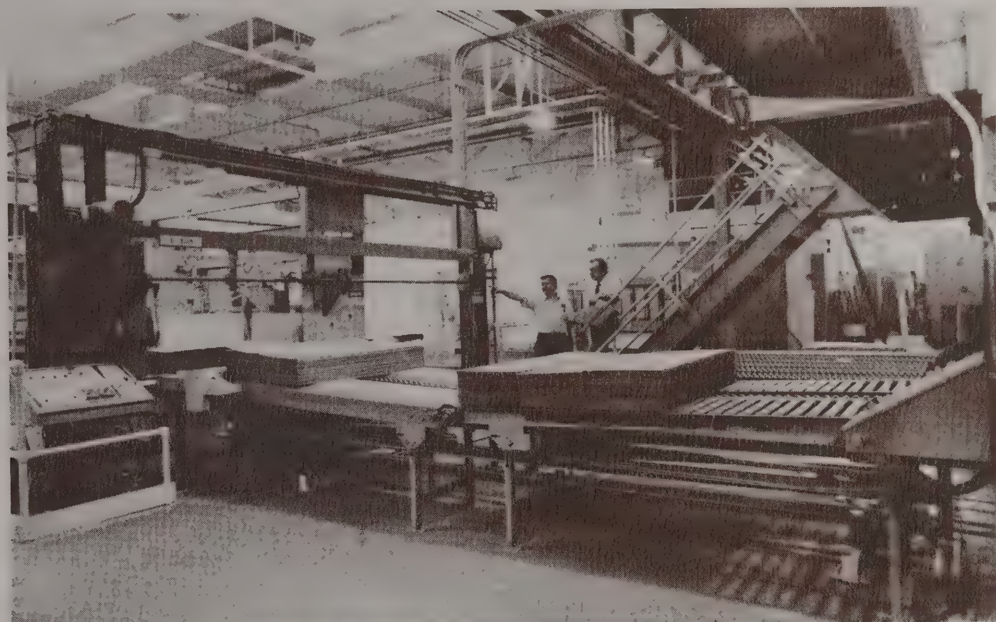
Eastern Coated Papers Limited, a subsidiary in which Domtar recently acquired a controlling interest, experienced a year of consolidation following recent periods of satisfactory growth.

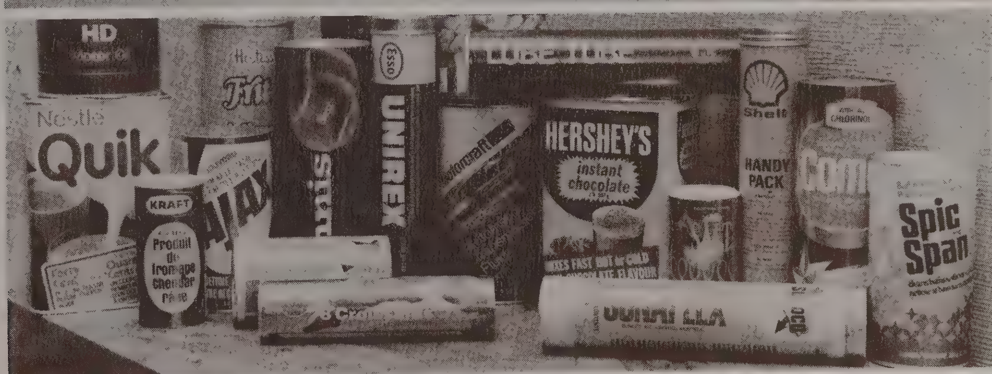
At the East Angus mill, labour relations deteriorated early in 1977 and a strike began in April. Because of the prevailing cost and profit picture, it was decided to close the mill. However, in subsequent negotiations, the employees agreed to various cost reduction measures to help maintain its operations. Domtar has agreed to continue operating the mill so long as it does not impose a cash drain on the Corporation's resources. Management is gratified that, while it took an extreme set of circumstances, solutions have been found which enable the Corporation both to preserve the community's chief source of employment and continue to serve the trade.

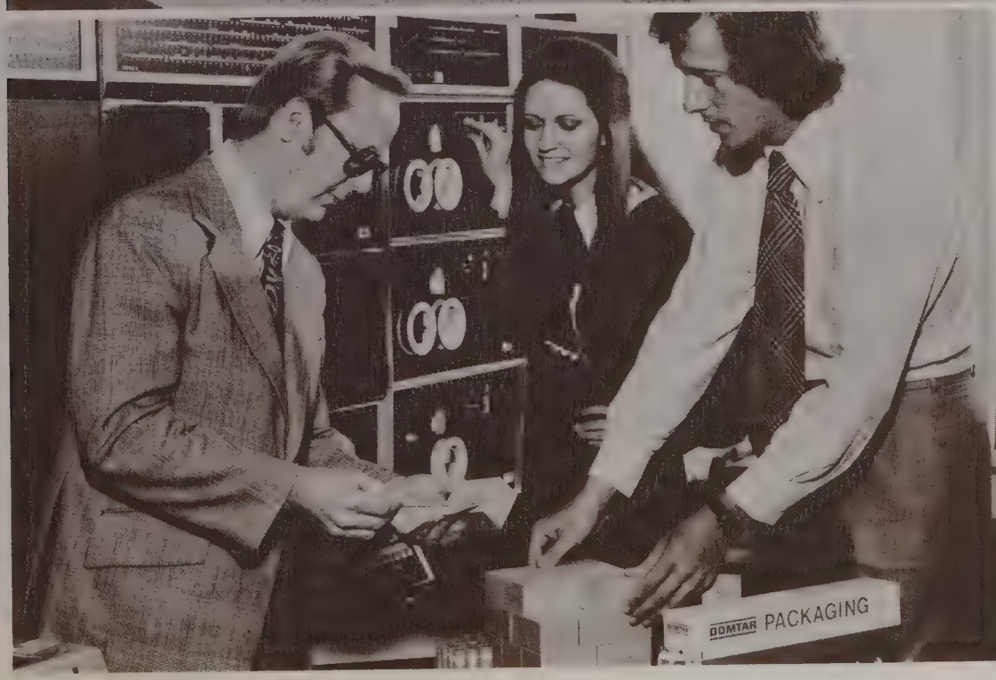
The continuation of firm markets in 1978 for the group's principal products is expected to generate an improvement in operating profit.

Packaging Sales
(millions of dollars)









Packaging

The recently installed corrugator stacker at Domtar Packaging's Montreal plant can automatically adjust for changes in customer orders.

Domtar Packaging's Composite Can Division is Canada's largest manufacturer of small fibre containers for fruit juices, dough, motor oil, cleansers and other products.

Domtar Packaging customers now benefit from computer technology. The new CORR-PAC® system of analyzing corrugated packaging requirements by computer enables sales service personnel to provide optimal product and distribution efficiency at the lowest possible cost. In the photo are Nick Bishop, Manager, Technical Sales Service, Judy Berkowski and Howard Hutchison, Salesman.

Report on Operations — *Domtar Construction Materials*

Principal Products:

Arborite® Products division
ARBORITE® decorative and industrial plastic laminates; particleboard; and CLADBOARD® decorative laminates.

Gypsum, Roofing and Insulation Products division
Asphalt shingles; roll roofing, sheathing and panel board and CEL-U-CON® 25 non-combustible roofboard; ceiling tiles and grid panels; linear ceiling systems; partition systems; gypsum lath, sheathing and wall panelling; plasters; plastic conduit; and Fiberglas® building insulation.

Masonry Products division
Clay brick and HAYDITE® lightweight aggregate.

®Registered Trade Mark

Even though the year's results were significantly below expectations, there was a marked improvement in several major product lines. Record sales of $197.4 million, 14.8% above the previous record established in 1976, unfortunately were not matched by record earnings. The operating profit of $10.4 million cannot be judged satisfactory when related to sales.

The largest single factor affecting the group's results was the continued unsatisfactory performance of the particleboard and Cladboard® decorative panel plant in Huntsville. Expectations of satisfactory operations at the plant proved unfounded due to mechanical difficulties which beset the facility throughout the year. An additional capital outlay was recently made to correct them. Since, in our view, the problem was directly attributable to faulty design, fabrication and installation, litigation has been undertaken to recover replacement costs and loss of profit.

Although overall profit continued to be adversely affected by an unfavourable product mix, market conditions were generally strong enough to enable higher prices and improved plant net realizations to keep pace with normal production cost increases. The high level of imports from the United States which disrupted the Canadian market in 1976 was not as significant a factor in 1977 due to an active residential construction program in that country. In fact, activity levels in the United States, combined with a devalued Canadian dollar, resulted in export opportunities developing for Canadian manufacturers in several product lines.

Also on the positive side was the more reasonable position taken by the construction trades in contract negotiations and the fact that operations throughout the year were free of work stoppages. Energy costs and prices for raw materials derived from petroleum products continued to escalate, generally reflecting increases in the wellhead price of oil.

As a result of the upgrading of building standards, energy conservation programs and other economies, sales of Fiberglas® building insulation were restricted only by the availability of material. Profit margins from these sales reversed the downward trend of the past few years.

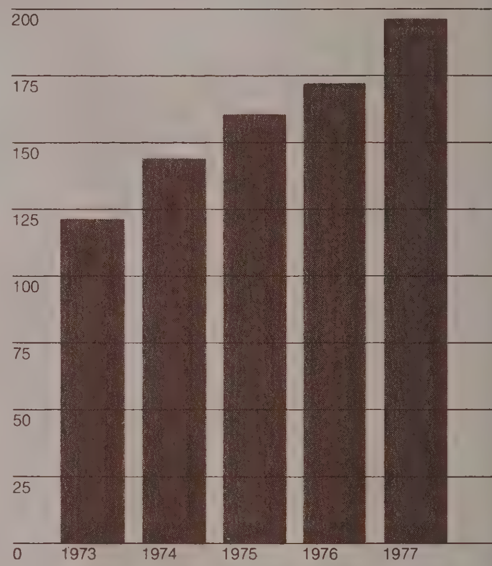
Residential construction, our major market, provided the real surprise of the year. Following a record 273,000 starts in 1976 and the increase in unsold units at the end of that year, it was generally expected that there would be a marked decline in 1977 starts. While housing starts at 246,000 units were 10% below the record level, completions at 255,000 units and residential construction expenditures were at an all time high. The strong Federal government programs for assisted home ownership (AHOP) and assisted rental (ARP), plus direct grants in many provinces, accounted for an increased percentage of the starts and are clear evidence of an ever decreasing control of this market by private enterprise.

Strong evidence exists that the rapid escalation in house prices, both new and resale, was significantly dampened due to the increase in housing availability and the depressed state of the economy. Other building construction expenditures were essentially at the same level as experienced in 1975 and 1976.

Capital expenditures in 1977 were substantially below recent years when the group was completing the Huntsville facility and undertaking significant cost reduction projects. However, the most aggressive capital expenditure program in several years will be undertaken in 1978.

Expenditures for the previously announced new gypsum wallboard plant at Caledonia, Ontario, the installation of equipment for the manufacture of fire rated ceiling panels at Cornwall, and various cost reduction projects are scheduled.

Construction Materials Sales
(millions of dollars)



Energy conservation measures, particularly in clay brick manufacturing, resulted in significant savings. The application of improved technology, in some instances without capital expenditures, resulted in both cost reductions and capacity increases. Management's emphasis on cost control for marketing, advertising and administrative expenses resulted in these being well below budget.

As January 1, 1978, is "M-Day" for the construction industry in Canada, efforts are being made to have our products available in metric measurements as quickly as possible. While Imperial dimensions undoubtedly will be required for some time, simple economics dictate that a rapid transition be made.

On balance, the outlook for 1978 is variably encouraging depending on the market being served. The projected moderate improvement in economic conditions, a slowing down in inflation, increased consumer confidence and a rise in export opportunities are all positive factors for the residential and other construction markets.

Housing start estimates of approximately 240,000 units, the large number of units under construction at the beginning of the year and a projected increase in repair and modernization activity indicate a good market potential in 1978. Some strengthening of the non-residential building construction market, after a generally flat level of activity over the past three years, is also expected.

Construction Materials

Domtar's Central Engineering Department is the General Contractor for a major expansion at the Corporation's wallboard plant in Caledonia. Project planners include Chuck Bennett, Design Engineer — Process, Tom Oosterhoff, General Manager, Gypsum products, Jim Dodd, Project Manager, Central Engineering and Grant Hepburn, Director of Engineering.

Sales Representative Art Manchur looks over the application of Fiberglas® insulation at the Delvista pre-fab home construction plant in Ste. Julie, Quebec.

Gerry Duffey, Advertising and Sales Promotion Manager for Domtar Construction Materials, coordinated production and distribution of a Metriguide designed especially for the construction industry.

Domtar Chemicals Group

Principal Products:

CDC division
Synthetic detergents; wetting agents; carboxymethylcellulose; dyestuffs; and pigments.
Lime division
Limestone; hydrated lime; and quicklime.
Sifto Salt division
SIFTO® products — ice control, chemical, industrial and table salt.
Tar & Chemical division
Coal tar pitches and acids; creosote; napthalene; and phthalic anhydride.
Wood Preserving division
Pressure treated wood.

® Registered trade mark

Results achieved by the Chemicals group showed a slight improvement over 1976 due to an 8.3% increase in sales and the effects of a cost reduction program.

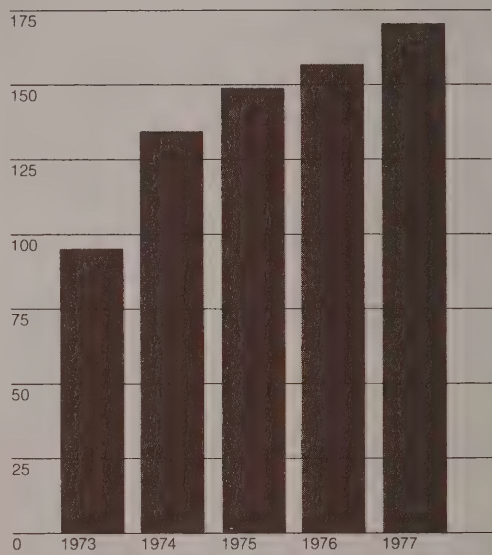
Chemical Developments of Canada Limited became a wholly owned subsidiary in May 1977 through the purchase of the minority interest held by GAF Corporation. Through a long term contract, the CDC division will continue to distribute in Canada dyestuffs and chemicals manufactured by GAF. Opportunities are being pursued for significant expansion of the division's operations in Canada and the United States and progress is anticipated in 1978. Substantial capital outlays were made in 1977 for pollution abatement equipment in the plant at Longford, Ontario. The new installation, which went into operation in December, is expected to meet environmental regulations for many years to come at the price of added labour and chemical treatment costs. Although the division's sales are expected to grow by some 10% in 1978, profits are anticipated to be somewhat lower due to higher operating costs and the continued sluggishness of the Canadian economy.

The Lime division experienced a difficult year, due primarily to sharp cutbacks by United States steel producers and the Quebec construction industry. Lime demand by the paper mills was also weak. Steel imported from offshore countries into Canada and the United States, particularly during the latter half of the year, adversely affected operating results at the division's Beachville, Ontario, and Bellefonte, Pennsylvania, plants. The outlook for 1978 is not promising since the major industries served by the division — steel, papermaking and construction — are all expected to operate below capacity. With rising labour and energy costs forcing manufacturing costs upwards, the division will be hard pressed to maintain a satisfactory level of profit.

Lower than expected volumes in all areas except railway tie treating characterized the 1977 operations of the Wood Preserving division. Weak demand, coinciding with an increase in industry capacity, depressed product prices. To minimize the adverse effects on profit margins, stringent cost control was required. Capital investment was limited to the installation of dry kilns at the Truro, Nova Scotia, and New Westminster, British Columbia, plants and the replacement of the railway tie adzing, boring and incising mill at Delson, Quebec. Capital expenditures will be considerably higher in 1978. Research and development were directed mainly towards solving technical problems associated with the introduction of a new product and compliance with environmental standards. Efforts to improve pollution control and product quality will continue in 1978 as will emphasis on the development of new preservatives. Business volume in 1978 is expected to be comparable with 1977 levels.

Sales of the Tar & Chemical division improved over the 1976 level by 32% and profits increased substantially due to the absence of strikes affecting the operations of major customers, a situation which had beset the industry in 1976. However, demand for coal tar pitch fell below normal due to low industrial activity, particularly in the steel industry. Sales of wood preservatives declined as utilities and railways reduced maintenance budgets. No improvement is indicated in 1978. Raw material costs continue to increase in step with crude petroleum prices and more sharply than the average inflation rate. The effect of increased fuel costs has been partially offset by the substantial savings realized through an energy conservation program introduced in 1976. Not only has energy consumption per unit of production been reduced by 25% below past levels but further benefits are expected as a result of improvements to equipment and operating processes. Sales volume in 1978 is expected to grow by 25% mainly as a result of higher selling prices.

Chemical Sales
(millions of dollars)



Only a marginal increase in profits is expected.

Unusual weather patterns in Canada and the north central United States in early 1977 adversely affected the Sifto Salt division's results, causing earnings to remain at 1976 levels. General trade sales were harmed by the economic slowdown in Canada while a strike at a major chemical producer and a cutback in the pulp and paper sector significantly reduced sales of rock salt. Evaporated salt sales improved appreciably although producing plants continued to operate below capacity. Increasing energy costs led to the curtailment of sales to low return markets. Efforts are being made to expand distribution facilities with a view to improving the utilization of existing capacity. An eighteen day strike at the Goderich, Ontario, mine in May affected general trade sales, delayed marine shipments of rock salt and made it difficult to meet inventory requirements before the close of navigation. In the United States, the mine at Cote Blanche, Louisiana, operated at above forecast levels and financial results improved following increases in the selling price of industrial and highway salt. A modest recovery for general trade and chemical sales is predicted in 1978. With increased penetration of industrial markets and a continued improvement in selling prices, the Cote Blanche mine is expected to make a bigger contribution in 1978.

Chemicals

Limestone is shipped in 8,000-ton barges from Domtar's quarry in Blubber Bay, British Columbia, to the Corporation's processing plant in Tacoma, Washington.

A well planned energy conservation program at Domtar's Tar & Chemical plant in Hamilton, Ontario, is saving the operation $240 thousand annually. Here, Mechanic Jack Mackie and Maintenance Foreman Will Hogan apply insulation to a steam line.

Maurice Wang, Senior Assistant at the C.D.C. Division laboratory in Pointe Claire, Quebec, prepares a solution for dyeing paper.

Domtar Inc. and Subsidiaries
Consolidated Statement of Earnings and Retained Earnings
year ended December 31

	1977	1976
Revenue:		
Sales	**$1,009,507,537**	$ 886,768,907
Investment and sundry income	**8,956,574**	9,608,165
Gain on disposal of fixed assets	**—**	1,612,051
	1,018,464,111	897,989,123
Expenses:		
Cost of sales and selling and administrative expenses	**920,837,494**	828,692,270
Depreciation	**38,907,073**	35,455,101
	959,744,567	864,147,371
Earnings before interest, income taxes and minority interest	**58,719,544**	33,841,752
Interest on funded debt	**16,022,413**	13,292,673
Interest on other indebtedness	**863,630**	959,677
	16,886,043	14,252,350
Earnings before income taxes and minority interest	**41,833,501**	19,589,402
Income taxes — current	**12,770,000**	3,730,000
— deferred	**950,000**	4,170,000
	13,720,000	7,900,000
Earnings before minority interest	**28,113,501**	11,689,402
Minority interest	**1,273,299**	1,126,785
Net earnings	**26,840,202**	10,562,617
Retained earnings at beginning of year	**188,590,861**	193,390,735
	215,431,063	203,953,352
Dividends:		
Preference shares, $1 per share	**512,916**	535,191
Common shares, 80¢ per share (1976 — $1)	**11,861,840**	14,827,300
	12,374,756	15,362,491
Retained earnings at end of year	**$ 203,056,307**	$ 188,590,861
Earnings per common share	**$1.78**	$0.68

See accompanying summary of accounting policies and notes to financial statements.

Domtar Inc. and Subsidiaries

Consolidated Statement of Changes in Financial Position

year ended December 31

	1977	1976
Funds provided by:		
Net earnings	**$ 26,840,202**	$ 10,562,617
Gain on disposal of fixed assets	**—**	1,612,051
	26,840,202	8,950,566
Depreciation	**38,907,073**	35,455,101
Deferred income taxes	**950,000**	4,170,000
Minority interest	**1,273,299**	1,126,785
Other	**199,035**	85,679
Cash flow from operations	**68,169,609**	49,788,131
Decrease (increase) in investments and advances	**141,560**	(680,118)
Issue of funded debt	**—**	48,854,152
Sale of investments	**—**	1,235,000
Disposal of fixed assets	**4,635,821**	4,401,083
	72,946,990	103,598,248
Funds used for:		
Fixed assets	**37,988,934**	44,364,743
Funded debt	**16,560,000**	8,897,000
Minority interest	**3,913,377**	1,058,672
Dividends	**12,374,756**	15,362,491
Purchase of subsidiary companies, less $7,839,136 working capital at acquisition	**12,694,815**	5,144,067
Par value of preference shares purchased	**523,463**	—
	84,055,345	74,826,973
Increase (decrease) in working capital	**(11,108,355)**	28,771,275
Working capital at beginning of year	**247,963,914**	219,192,639
Working capital at end of year	**$236,855,559**	$247,963,914
Changes in components of working capital:		
Receivables	**$ 20,002,797**	$ 18,888,369
Inventories	**(2,547,931)**	5,626,483
Prepaid expenses	**(81,405)**	851,533
Payables	**(1,934,535)**	(8,773,796)
	15,438,926	16,592,589
Income and other taxes payable	**(4,203,877)**	1,755,149
Dividends payable	**11,142**	2,981,621
Funded debt due within one year	**(8,370,000)**	(512,000)
Cash and short-term investments less bank indebtedness	**(13,984,546)**	7,953,916
Increase (decrease) in working capital	**$ (11,108,355)**	$ 28,771,275

See accompanying summary of accounting policies and notes to financial statements.

Domtar Inc. and Subsidiaries
Consolidated Balance Sheet
December 31

Assets

	1977	1976
Current assets:		
Cash and short-term investments, at cost (approximates market value)	**$ 85,139,091**	$ 94,697,172
Receivables	**150,949,705**	130,946,908
Inventories	**143,344,360**	145,892,291
Prepaid expenses	**3,431,834**	3,513,239
	382,864,990	375,049,610
Investments and advances:		
Listed securities	**3,453,801**	3,453,801
Other investments and advances	**8,247,739**	8,389,299
	11,701,540	11,843,100
Fixed assets:		
Plant, machinery and facilities	**811,652,679**	777,873,918
Timber limits and land	**31,386,368**	34,205,055
	843,039,047	812,078,973
Less: Accumulated depreciation	**457,196,647**	433,377,428
	385,842,400	378,701,545
Intangible assets and deferred charges:		
Goodwill	**864,851**	960,947
Unamortized debt discount and expenses	**1,246,025**	1,348,964
	2,110,876	2,309,911
	$782,519,806	$767,904,166

APPROVED BY THE BOARD:

A. D. Hamilton, Director

M. C. G. Meighen, Director

Liabilities and Shareholders' Equity

	1977	1976
Current liabilities:		
Bank indebtedness	**$ 12,191,600**	$ 7,765,135
Payables	**113,136,143**	111,201,608
Income and other taxes payable	**8,617,384**	4,413,507
Dividends payable	**3,182,304**	3,193,446
Funded debt due within one year	**8,882,000**	512,000
	146,009,431	127,085,696
Funded debt	**173,939,000**	190,499,000
Deferred income taxes	**103,492,500**	102,542,500
Minority interest	**11,225,220**	13,865,298
Shareholders' equity:		
Stated capital —		
$1 cumulative redeemable preference shares without nominal or par value, redeemable at $25 per share		
Authorized and outstanding — 512,916 shares	**12,053,526**	12,576,989
14,827,300 common shares	**132,743,822**	132,743,822
Retained earnings	**203,056,307**	188,590,861
	347,853,655	333,911,672
	$782,519,806	$767,904,166

See accompanying summary of accounting policies and notes to financial statements.

Domtar Inc. and Subsidiaries
Summary of Significant Accounting Policies
December 31, 1977

The Corporation follows the generally accepted accounting principles described below. These, together with the notes which follow, should be considered an integral part of the consolidated financial statements.

Principles of consolidation:
The accompanying financial statements include the accounts of Domtar Inc. and all its subsidiaries.

Translation of foreign currencies:
Current assets and current liabilities in foreign currencies are translated into Canadian dollars at exchange rates prevailing at December 31, 1977 or at rates related to forward exchange contracts with the exception of U.S. $50,000,000 included in short-term investments. These funds, which were obtained through the issue of the 9⅝% Series "H" sinking fund debentures, are intended for investment in long term assets and accordingly have been translated at the same rate of exchange as the related debt which has been translated at the rate prevailing at the date of issue. Fixed assets and related depreciation and other long term assets and liabilities are translated at rates of exchange in effect at the dates of the transactions. Items affecting net earnings (other than depreciation) are translated at the average rates for the year.

Valuation of inventories:
Inventories of pulpwood, raw materials and operating and maintenance supplies are valued at the lower of cost and replacement cost. Finished goods, including work in process, are valued at the lower of cost and net realizable value.

Fixed assets and depreciation:
Fixed assets are recorded at cost. The cost and related accumulated depreciation of items retired or disposed of are removed from the books and any gains or losses are included in the consolidated statement of earnings. Depreciation is provided on the straight-line method using rates based on the estimated useful lives of the assets which are generally as follows:

Production machinery	12-16 years
Logging equipment	Up to 6 years
Automobiles	4 years
Buildings	Up to 40 years

Expenditures for repairs and maintenance are charged against earnings as incurred.

Income taxes:
The Corporation provides for income taxes on the tax allocation basis. The Corporation follows the flow-through method of accounting for the federal investment tax credit. The provision for deferred income taxes mainly arises as a result of depreciation being claimed for income tax purposes in excess of amounts of depreciation recorded for financial statement purposes.

Intangible assets and deferred charges:
Goodwill represents the excess of the cost of shares of acquired companies over the values attributed to the underlying net assets. The Corporation follows the policy of amortizing goodwill on a straight-line basis over periods not exceeding forty years.

Discount and expenses on funded debt are amortized over the terms of the related obligations.

Domtar Inc. and Subsidiaries
Notes to Consolidated Financial Statements
December 31, 1977

1. Inventories:	**1977**	1976
Logs and pulp chips	**$ 15,210,772**	$ 20,699,483
Raw materials and operating and maintenance supplies	**60,253,000**	55,247,000
Finished goods including work in process	**67,880,588**	69,945,808
	$143,344,360	$145,892,291

2. Investments and advances:	**1977**	1976
Listed securities, at cost, quoted value $3,995,500 (1976 — $3,733,500)	**$ 3,453,801**	$ 3,453,801
Other investments and advances, at cost:		
Secured loans to the Trustees for employees under the Corporation's stock purchase plan	**$ 14,370**	$ 114,716
Loans, mortgages and debentures	**7,809,061**	7,850,064
Shares	**424,308**	424,519
	$ 8,247,739	$ 8,389,299

3. Fixed assets:	**Cost**	**Accumulated depreciation (millions of dollars)**	**Net book value**
December 31, 1977 —			
Plant, machinery and facilities —			
Pulp and paper	**$405.0**	**$210.7**	**$194.3**
Packaging	**170.4**	**101.7**	**68.7**
Construction materials	**111.0**	**67.5**	**43.5**
Chemicals	**123.4**	**72.3**	**51.1**
Other	**1.8**	**.5**	**1.3**
Timber limits and land	**31.4**	**4.5**	**26.9**
	$843.0	**$457.2**	**$385.8**
December 31, 1976 —			
Plant, machinery and facilities —			
Pulp and paper	$381.7	$192.6	$189.1
Packaging	173.6	100.9	72.7
Construction materials	108.5	63.4	45.1
Chemicals	110.6	67.7	42.9
Other	3.5	2.8	.7
Timber limits and land	34.2	6.0	28.2
	$812.1	$433.4	$378.7

Notes (continued)

4. Funded debt:	**Maturity**	**1977**	1976
Domtar Inc. —			
Sinking fund debentures —			
5¼% Series "A"	1978	**$ 6,250,000**	$ 7,404,500
6¼% Series "B"	1980	**3,525,000**	4,274,000
5½% Series "C"	1982	**7,700,000**	7,731,000
5¾% Series "D"	1984	**10,244,000**	10,244,000
5⅝% Series "E"	1990	**26,600,000**	28,046,000
6¾% Series "F"	1987	**29,217,000**	30,617,000
11% Series "G"	1995	**50,000,000**	50,000,000
9⅝% Series "H" (U.S. $50,000,000)	1996	**49,295,000**	49,295,000
St. Lawrence Corporation Limited —			
First mortgage sinking fund bonds — 5% Series "C"	1978	**3,116,000**	3,574,000
Sinking fund debentures — 6¾% Series "A"	1980	**4,800,000**	5,861,000
		190,747,000	197,046,500
Less: Held for sinking fund		**7,926,000**	6,035,500
		182,821,000	191,011,000
Less: Due within one year		**8,882,000**	512,000
		$173,939,000	$190,499,000

Instalments due in each of the next five years:
1978 — $8,882,000 1979 — $640,000 1980 — $10,604,000 1981 — $7,600,000 1982 — $13,610,000

5. Acquisitions:

In May 1977, the Corporation acquired the remaining 49% of Chemical Developments of Canada Limited so that this Company became a wholly-owned subsidiary. The assets acquired were adjusted to fair value. The net assets acquired and consideration given are as follows:

Net assets acquired at book value	$2,816,917
Adjustment of net assets acquired to fair value	783,083
Net assets acquired for cash	$3,600,000

The Corporation also acquired the remaining 51% of the shares in the joint venture in Murdock-Domtar Inc. for a nominal consideration. In addition, the Corporation advanced $19,750,868 for the financing of the net assets of the company. This company, which is now a wholly-owned subsidiary, is included in the consolidated accounts at December 31, 1977.

Notes (continued)

6. Minority interest:	**1977**	1976
Preferred share equity in subsidiaries — St. Lawrence Corporation Limited — 66,653 5% preferred shares of $100 each, redeemable at $101 (after purchase for cancellation during the year of 4,280 shares)	**$ 6,665,300**	$ 7,093,300
Other	**375,200**	411,450
	7,040,500	7,504,750
Common share equity in subsidiaries	**4,184,720**	6,360,548
	$11,225,220	$13,865,298

7. Continuance and stated capital:

A Certificate of Continuance was issued to the Corporation on December 30, 1977 continuing it under the Canada Business Corporations Act and changing its name from Domtar Limited — Domtar Limitée to Domtar Inc. The Corporation has an authorized limit of 512,916 preference shares. There is no restriction on the maximum number of common shares that the Corporation is authorized to issue.

The Corporation purchased for redemption 22,275 preference shares for $275,739 during the year.

8. Amalgamation:

A Certificate of Amalgamation was issued on December 31, 1977 amalgamating the Corporation with twelve of its wholly owned subsidiaries effective on that date.

9. Pension plans:

The Corporation and its subsidiaries have pension plans for their employees. The cost charged against earnings in 1977 was $8,943,934 (1976 — $8,831,938). The liability for benefits in respect of past service remaining to be charged to operations approximated $22,428,000 at December 31, 1977. This cost will be amortized and funded over the next thirteen years.

10. Remuneration of directors and senior officers:

The aggregate direct remuneration paid or payable in 1977 by the Corporation and its subsidiaries to the directors and senior officers was $1,484,094 (1976 — $1,505,600).

11. Classes of business:

The following classes of business have been determined by the directors of the Corporation to be those which most accurately disclose the diversity of the operations of the Corporation and its subsidiaries.

	1977		1976	
	(millions of dollars)			
	Sales	**Operating profit**	Sales	Operating profit (loss)
Pulp and paper	**$ 460.4**	**$ 6.8**	$374.2	$(12.1)
Packaging	**194.6**	**13.6**	197.9	8.8
Construction materials	**197.4**	**10.4**	172.0	10.3
Chemicals	**169.8**	**20.1**	156.7	16.9
Inter-class eliminations	**(12.7)**	**—**	(14.0)	0.1
	$1,009.5	**50.9**	$886.8	24.0
Gain on disposal of fixed assets		**—**		1.6
Corporate income		**7.8**		8.2
Earnings before interest, income taxes and minority interest		**$58.7**		$33.8

Notes (continued)

12. Commitments and contingent liabilities:

The Corporation and its subsidiaries are contingently liable for $1,650,000 (1976 — $13,600,000) as guarantor of obligations of other companies and CMHC mortgages on employee homes.

Of the 1978 capital expenditure program the Corporation is committed for approximately $10,000,000.

There are outstanding lawsuits and claims against the Corporation as follows:

(a) Proceedings instituted by certain Cree Indians alleging that the mercury content of the environment has partly been caused by mercury discharges of the Corporation's chemical plant at Lebel-sur-Quévillon, Québec, and that they have exclusive rights to a territory in Northern Quebec including the location of the Lebel-sur-Quévillon pulp mill complex. They are claiming from the Corporation, jointly and severally with several other companies, an amount of approximately $5,200,000 in damages. In addition, they request that the Corporation be evicted from the area.

(b) Various lawsuits and claims amounting to $2,700,000 in the aggregate.

The Corporation is contesting these lawsuits and claims and does not consider that their outcome will have a material adverse effect on the Corporation and its subsidiaries.

13. Anti-inflation program:

The Corporation and its Canadian subsidiaries are subject to controls on prices, profits, employee compensation and dividends under the federal anti-inflation program enacted on October 14, 1975. The Corporation is of the opinion that it has complied with this legislation.

14. The Companies Act of British Columbia:

These financial statements comply with the disclosure requirements of the Canada Business Corporations Act and Regulations and the securities legislation of certain provinces in Canada, but do not purport to comply with all disclosure requirements of the Companies Act of British Columbia.

Auditors' Report

To the Shareholders of
Domtar Inc.:

We have examined the consolidated balance sheet of Domtar Inc. as at December 31, 1977 and the consolidated statements of earnings and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the financial position of the Corporation as at December 31, 1977 and the results of its operations and the changes in its financial position for the year then ended in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

PRICE WATERHOUSE & CO.
Chartered Accountants

Montreal, January 26, 1978

Domtar Inc. and Subsidiaries
Historical Review
(Dollars in millions except per share amounts)

Financial	**1977**	1976	1975	1974	1973
Sales and other revenues:					
Pulp and Paper	**460.4**	374.2	350.0	439.4	306.8
Packaging	**194.6**	197.9	166.0	193.9	145.2
Chemicals	**169.8**	156.7	149.4	134.3	95.2
Construction materials	**197.4**	172.0	160.1	144.1	122.1
Inter-class eliminations	**(12.7)**	(14.0)	(10.3)	(14.0)	(13.5)
Other revenues	**9.0**	11.2	11.9	9.0	6.3
	1,018.5	898.0	827.1	906.7	662.1
Earnings:					
Earnings before income taxes	**40.6**	18.5	59.2	147.0	67.2
Current income taxes	**12.8**	3.7	11.9	55.6	21.4
Deferred income taxes	**1.0**	4.2	12.0	8.9	5.2
Net earnings	**26.8**	10.6	35.3	82.5	40.6
Cash flow from operations	**68.2**	49.8	76.3	123.6	73.7
Capital investments	**50.7**	49.5	57.7	74.9	43.4
Net assets:					
Net fixed assets	**385.8**	378.7	364.3	339.2	294.8
Working capital	**236.9**	248.0	219.2	175.5	152.4
Investments and advances	**11.7**	11.8	14.3	19.1	26.4
Intangible assets and deferred charges	**2.1**	2.3	1.0	—	—
	636.5	640.8	598.8	533.8	473.6
Represented by:					
Funded debt	**173.9**	190.5	150.1	108.1	115.2
Deferred income taxes	**103.5**	102.5	97.8	85.8	76.5
Minority interest	**11.2**	13.9	12.2	12.2	11.6
Shareholders' equity	**347.9**	333.9	338.7	327.7	270.3
	636.5	640.8	598.8	533.8	473.6
Per common share:					
Earnings	**1.78**	0.68	2.34	5.53	2.70
Dividends	**0.80**	1.00	1.60	1.60	1.00
Cash flow	**4.56**	3.32	5.11	8.30	4.93
Shareholders' equity	**22.65**	21.67	22.00	21.25	17.33
Other statistics:					
Number of preference shareholders	**1,537**	1,613	1,654	1,671	1,784
Number of common shareholders	**22,244**	23,330	25,815	26,920	27,705
Common shares outstanding	**14,827,300**	14,827,300	14,827,300	14,827,300	14,827,300
Number of employees	**16,815**	17,520	17,637	18,450	18,017
Employees' salaries, wages and benefits	**297.3**	273.9	232.9	230.7	195.1

Pulp and Paper Production (tons)					
Newsprint	**215,882**	199,192	234,106	311,996	354,020
Kraft paper and board	**383,108**	354,213	300,219	453,990	449,690
Fine and specialty papers	**365,556**	350,985	265,858	372,587	384,012
Market pulp	**207,624**	160,802	160,648	253,078	234,357
	1,172,170	1,065,192	960,831	1,391,651	1,422,079

Inflation Accounting

In 1977, a year in which the Canadian economy continued to function in an inflationary environment, only limited progress was made to develop a method of inflation accounting which could universally be adopted for financial reporting purposes. In the countries which have suffered prolonged periods of high inflation, the deficiencies of the financial statements prepared under the long established historical cost accounting concepts have become obvious. Hence, the need to develop a new accounting methodology in response to the increasingly apparent limitations inherent in the historical cost accounting conventions has become even more pressing.

In Canada, the most significant development in this area in 1977 was the completion of the work done by the Ontario Government's Committee on Inflation Accounting which submitted its report to the Treasurer of Ontario in June 1977. While this report did not recommend the adoption of a particular inflation accounting method, the Committee did propose, as an interim step, the introduction of a new statement designed to reflect the effects of inflation on funds available for distribution or expansion, rather than to express the impact in the conventional terms of net earnings.

The Federal government has not as yet formally recognized a method of inflation accounting for tax purposes. Instead, it has, for the first time, evidenced tangible recognition that income taxes are being paid on illusory profits by introducing a 3% inventory allowance as a deduction from taxable income to provide some relief from the taxation of profits arising from the impact of inflation on inventory values.

In 1977, Domtar continued to express its concern as to the distortion of reported earnings using historical cost accounting concepts and its anxiety persists as to the impact of inflation on the cash flows generated from its operations available for re-investment. The Corporation actively supports the efforts of industry, the financial community, the accounting profession and governments directed towards developing a satisfactory method of accounting for inflation and urges all such interested groups to join together to achieve that objective. The importance of profiling the effects of inflation outweighs the necessity to develop the perfect system which may later be achieved through refinements.

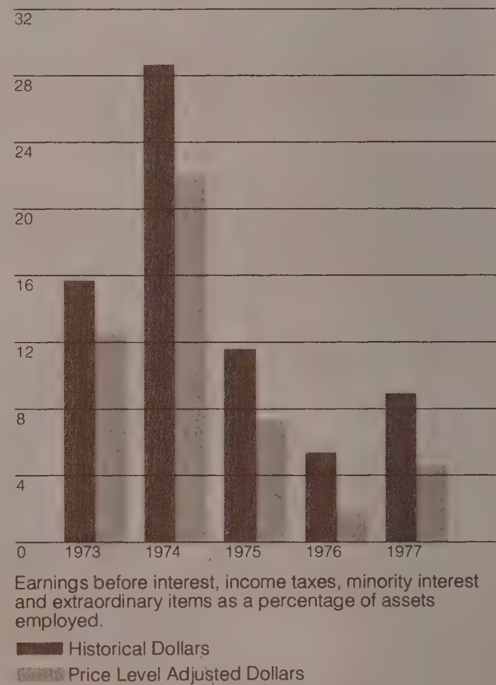
The Corporation is continuing the practice established in 1974 of including price-level adjusted financial information in this report. While the general price-level inflation accounting concept has not gained universal recognition, its use recognizes in part the effect of changing prices caused by inflation and to that extent, is considered to be useful at this time.

The application of price-level accounting concepts has the effect of restating the 1977 reported earnings of $1.78 per common share to $0.53 per common share before extraordinary items. Under price level accounting, extraordinary losses of $0.44 per common share were realized on disposals of fixed assets and reduced net earnings to $0.09 per common share.

A major impact of the use of price-level accounting, as indicated on the graph, is the reduction in the return (before income taxes and extraordinary items) on assets employed from 8.9% to 4.5% and from 5.3% to 1.8% for 1977 and 1976 respectively.

Following the recommendations of the report by the Ontario Committee referred to previously, the Corporation provides below a statement reflecting the impact of inflation on funds available for distribution or expansion. This statement is intended to reflect the additional sums of money which should be set aside to cover the effects of inflation on inventory values and the replacement cost of existing plant and equipment and which conceptually would not be available for other purposes. The main attribute of this statement is that it directs its attention to the funds available to the Corporation. In the final analysis, it is the availability of funds which will have the greatest influence on a corporation's ability to sustain and improve its competitive position.

Percentage Return Before Taxes on Assets Employed 1973-1977
(Percent)



Earnings before interest, income taxes, minority interest and extraordinary items as a percentage of assets employed.

Statement of Effects of Inflation on Funds Available for Distribution or Expansion

for the year ended December 31, 1977
(in thousands of dollars)

Funds generated from operations (from statement of changes in financial position)		$ 68,170
Funds required to finance original cost of productive assets (historical cost depreciation)		38,907
		29,263
Funds required to finance increased cost of maintaining operating capacity (Notes)		
Inventories	$ 6,333	
Plant, machinery and equipment	28,474	
	34,807	
Less: Additional funds which may be available from borrowings	5,917	28,890
Funds available for distribution or expansion		$ 373

Notes

a. The increased cost of replacing inventories ($6,333,000) represents the difference between the historical cost and the current cost of goods sold at the date of sale.

b. The increased cost of maintaining the operating capacity of productive assets ($28,474,000) represents the difference between depreciation determined on an historical cost basis and depreciation indexed for the effects of inflation, using the business investment component of the Gross National Expenditure Implicit Price Index.

c. The extent to which additional funds may be available from borrowings ($5,917,000) is based on the Corporation's ability to finance the increased cost of maintaining operating capacity without impairing its financing posture.

Directors and Officers

Directors

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Pierre Côté, C. M., Quebec,
Chairman of the Board, Laiterie Laval Limitée

H. Roy Crabtree, Montreal,
Chairman and President, Wabasso Limited

Robert Després, Quebec,
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President and Chief Executive Officer, Hollinger Mines Limited

Roger T. Hager, Vancouver,
Director, The Canadian Fishing Company Limited

Alex D. Hamilton, Montreal,
President and Chief Executive Officer, Domtar Inc.

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Senior Partner in the legal firm of Ogilvy, Montgomery, Renault, Clarke, Kirkpatrick, Hannon & Howard

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John A. McDougald, Toronto,
Chairman and President, Argus Corporation Limited

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Arthur Ross, New York,
Vice Chairman and Managing Director, Central National Corporation

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Alex E. Barron

Pierre Côté

H. Roy Crabtree

Alex D. Hamilton

A. Bruce Matthews

John A. McDougald

Maxwell C. G. Meighen

Arthur Ross

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Chairman of the Board

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President and Chief Executive Officer

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Executive Vice-President

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Vice-President — Administration and Secretary

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Vice-President — Industrial Relations and Human Resources

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Vice-President

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Vice-President

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Controller

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General Counsel and Assistant Secretary

F. E. Hertha,
Treasurer

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Assistant Treasurer

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Domtar Construction Materials
President — J. Cochran

Domtar Packaging
President — W. R. Lawson

Domtar Pulp & Paper Products
President — J. H. Robertson
Executive Vice-President — R. R. Pinard

Domtar Fine Papers
Vice-President and General Manager — B. R. Grant

Domtar Forest Products
Vice-President — A. S. Fleming

Domtar Newsprint
Vice-President and General Manager — G. R. Simpson

Domtar Pulp
Vice-President and General Manager — T. R. Hall

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Halifax, N.S.; Saint John, N.B.; Montreal, Que.; Toronto, Ont.; Winnipeg, Man.; Regina, Sask.; Calgary, Alta.; Vancouver, B.C.

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New York, N.Y.

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Contents

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